Supreme Court, U.S.
FILED
JAN 29 1999
CLERK

(2)

No. 98-1096

In The

Supreme Court of the United States

October Term, 1998

CENEX, INC. AND SUBSIDIARIES,

Petitioners,

v.

UNITED STATES,

Respondent.

On Petition For A Writ Of *Certiorari* To The United States Court Of Appeals For The Federal Circuit

BRIEF OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF *CERTIORARI*

GEORGE W. BENSON
(*Counsel of Record*)
KEVIN J. FEELEY
McDERMOTT, WILL & EMERY
227 W. Monroe Street
Chicago, Illinois 60606-5096
(312) 372-2000
Counsel for Amicus Curiae

Of Counsel:
JAMES S. KRZYMINSKI
National Council of Farmer Cooperatives
50 F Street, N.W.
Washington, D.C. 20001
(202) 626-8700

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

33PP

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES iii

INTEREST OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES 1

1. Closely-knit systems of farm supply cooperatives have evolved over the years to meet the need of farmers for a reliable source of quality farm supplies at a reasonable cost 2

2. Cooperatives that are part of a farm supply cooperative system are normally required to own stock of other system entities to gain access to the farm supplies that flow through the system 6

3. NCFC is concerned that the decision of the Court of Appeals for the Federal Circuit improperly precludes cooperatives which are part of a farm supply cooperative system from treating stock in other system entities as an ordinary asset under the inventory exclusion of Section 1221(1) no matter what the circumstances 9

SUMMARY OF ARGUMENT 13

REASONS FOR GRANTING THE WRIT 14

1. The decisions of the Court of Federal Claims and Court of Appeals for the Federal Circuit in this case indicate that confusion exists as to whether under appropriate circumstances capital stock can be treated as an ordinary asset, and this Court should resolve that confusion 14

2. Because this case involves ownership of stock of a cooperative which is part of a farm supply cooperative system, it presents a compelling vehicle for a reexamination of the scope of the inventory exclusion 17

TABLE OF CONTENTS – Continued

Page

3. This is an important issue for members of NCFC 19

CONCLUSION 20

TABLE OF AUTHORITIES

Page

CASES

Arkansas Best Corp. v. Commissioner, 800 F.2d 215 (8th Cir. 1986), *aff'd*, 485 U.S. 212 (1988) ..... *passim*

Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) 12

Cenex, Inc. v. United States, 38 Fed. Cl. 331 (Ct. Fed. Cl. 1997), *aff'd*, 156 F.3d 1377 (CAFC 1998) .. 5, 9, 12, 19

Circle K Corporation v. United States, 23 Cl. Ct. 665 (1991), vacated by unpublished order dated November 15, 1996, unofficially reported at 97-1 USTC ¶50,338 (Ct. Fed. Cl. 1996) 16

Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) 14, 18

Federal National Mortgage Association v. Commissioner, 100 T.C. 541 (1993) 15

FS Services, Inc. v. United States, 413 F.2d 548 (Ct. Cl. 1969) 10

United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1974) 8, 9

STATUTES

26 U.S.C. § 1221 14

26 U.S.C. § 1221(1) 9, 16

26 U.S.C. § 1221(4) 15

REGULATORY RULING

Rev. Rul. 78-402, 1978-2 Cum. Bull. 138 8

INTEREST OF THE NATIONAL COUNCIL OF FARMER COOPERATIVES

The National Council of Farmer Cooperatives ("NCFC"),[1] with the consent of the parties,[2] submits this Brief as *amicus curiae* in support of the Petition for a Writ of *Certiorari* filed by Petitioner Cenex, Inc. and Subsidiaries ("Cenex").

NCFC is a nationwide association of cooperative businesses owned and controlled by farmers. Its membership includes nearly 70 major farmer marketing, supply and credit cooperatives (one of whom, Cenex Harvest States Cooperatives, is the successor by merger to Petitioner), plus the state councils of cooperatives in thirty-one states. NCFC's members, in turn, represent nearly 4,000 local cooperatives, with a combined membership that includes approximately 1.6 million farmers in the United States. NCFC members handle almost every type of agricultural commodity produced in the United States.

Farmer cooperatives were formed, and operate today, to meet the needs of farmers for reliable and fairly-priced sources for farm supplies (such as fertilizer, seed, feed, petroleum products, herbicides and pesticides), services and credit and to provide farmers assistance in effectively marketing the commodities that they produce. Some focus on serving a single function, such as providing farm supplies to members (such cooperatives are referred to as "supply cooperatives") or helping members market

---

[1] This brief was prepared by counsel for the *amicus curiae*; counsel for a party did not author this brief in whole or in part. This brief was paid for by *amicus curiae*. No other persons made a monetary contribution to the preparation or submission of the brief. Cenex Harvest States Cooperatives (successor by merger to Petitioner) is one of nearly 70 cooperative members of *amicus curiae*.

[2] Copies of NCFC's letters to counsel for the parties requesting their permission to file an *amicus* brief and their favorable responses accompanied this brief when filed.

a particular kind of crop (such cooperatives are referred to as "marketing cooperatives"). Others perform several different functions for their members. Whatever their function, farmer cooperatives are an extension of the farming operations of their members. Their importance to agriculture is demonstrated by the fact that most American farmers are affiliated with one or more cooperatives.

NCFC and its members have long been concerned that the unique features of farm supply cooperative systems and of the role of capital stock in such systems might not be properly understood when considering whether stock owned by one member of a system in another should be characterized as a capital or ordinary asset. NCFC believes that such stock is properly characterized as an ordinary asset by reason of the inventory exclusion to the capital asset definition where it is acquired and held to obtain access to a reliable source of quality farm supplies at a reasonable cost. The lower courts erroneously interpreted prior decisions of this Court in concluding otherwise. For reasons described in detail in this brief, NCFC believes that this case presents an important issue on which guidance is needed to resolve uncertainties created by prior opinions of this Court. This Court should grant *certiorari* and reverse the decision of the Court of Appeals for the Federal Circuit.

1. Closely-knit systems of farm supply cooperatives have evolved over the years to meet the need of farmers for a reliable source of quality farm supplies at a reasonable cost.

Most of the farmer cooperatives in existence today were formed by farmers who believed the best way to enhance their ability to make a living by farming was through collective action on a cooperative basis. Many of the major farm supply cooperative systems in existence today arose because farmers could not obtain a reliable

source of quality products needed to conduct their farming operations at a reasonable cost. For instance, the major oil companies were slow to service rural areas when agriculture was mechanizing, preferring to focus instead on urban areas, so farmers formed cooperatives to obtain reliable supplies of quality petroleum products at reasonable prices.

Many of the first farm supply cooperatives formed in this country were what are now referred to as "local" cooperatives. The members of local cooperatives are farmers in a relatively small local region, often defined along county lines. Local farm supply cooperatives are owned and controlled by their members. They operate on a cooperative basis. Their net earnings (often referred to as "net savings") are shared by their members on a patronage basis. Sharing net savings on a patronage basis means allocating the net savings among member-patrons upon the basis of the quantity or value of the business each member does with the cooperative during the year, without regard to the amount of stock the member may own in the cooperative. Earnings allocated to member-patrons are distributed each year by way of distributions referred to as "patronage dividends." Because cooperatives distribute their net savings as patronage dividends, they are often described as operating "at cost." For supply cooperatives, patronage dividends are often viewed as akin to a purchase price rebate.

Many of the early local farm supply cooperatives operated as group purchasing organizations, purchasing farm supplies in bulk from unrelated suppliers and reselling the supplies to their members. It did not take long for them to realize that they were too small to be effective in negotiations with unrelated suppliers. To better serve their farmer members, local farm supply cooperatives formed what are now referred to interchangeably as "federated" or as "regional" farm supply cooperatives to handle the purchasing function for them on a cooperative

basis. Many of the original federated farm supply cooperatives were formed along state lines, representing all the local farm supply cooperatives in a particular state. Over time many of the original federated farm supply cooperatives have combined in an effort to yet better serve their member local cooperatives, so the federated farm supply cooperatives in existence today typically serve local cooperatives in a multi-state area. The Petitioner in this case, Cenex, was one such federated cooperative.

Federated cooperatives are organized much like local cooperatives with one difference. The members of federated cooperatives are local cooperatives. The focus of federated farm supply cooperatives is providing local farm supply cooperatives with the farm supplies they sell to farmers. This means that federated farm supply cooperatives share the commitment of local farm supply cooperatives to serving as reliable sources of quality farm supplies at a reasonable cost. Federated farm supply cooperatives are owned and controlled by their member local farm supply cooperatives. While local cooperatives are normally required to own stock in federated cooperatives in order to do business with them, the net savings of federated farm supply cooperatives are shared by their members on a patronage basis, not on the basis of stock ownership. Those net savings are distributed in the form of patronage dividends.

Eventually, many federated farm supply cooperatives concluded that they could best serve their local cooperative members (and the farmer members of those cooperatives) if they went beyond acting simply as group purchasing organizations by actually owning production facilities and other links in the supply chain. This ownership took a number of different forms. Some of the larger federated farm supply cooperatives independently acquired and operated production facilities, either owning them directly or through wholly-owned or controlled subsidiaries. Other federated supply cooperatives joined together to create what are often referred to as "inter-

regional" cooperatives to produce the products destined for sale to the local cooperatives and their farmer members. These cooperatives often joined together because production economies dictated that the manufacturing facilities produce on a scale that exceeded the needs of a single federated farm supply cooperative and its members. The issue in this case involves the character of the interest that Petitioner had in one such inter-regional cooperative, a cooperative known as Energy Cooperative, Inc. ("ECI"), which, in the words of the Court of Appeals for the Federal Circuit, was formed by Cenex and eight other federated cooperatives "in order to obtain an assured supply of refined petroleum products . . . . " 156 F.3d 1377, at 1377.

Inter-regional cooperatives are organized much like federated farm supply cooperatives, except that the members are federated cooperatives. The focus of inter-regional cooperatives is serving federated farm supply cooperatives. This means they share the mission of the federated farm supply cooperatives (and the local farm supply cooperatives that the federated cooperatives serve) of serving as a reliable source of quality farm supplies at a reasonable cost. Inter-regional cooperatives are owned and controlled by their members. While federated cooperatives are normally required to own stock in inter-regional cooperatives in order to do business with them, the net savings of inter-regional cooperatives are shared by their members on a patronage basis, not on the basis of stock ownership. Net savings are distributed to the federated farm supply cooperatives as patronage dividends.

As a result of this historical development, there exist in the cooperative community tightly-knit, highly-coordinated systems of farm supply cooperatives focused on assuring that farmers have reliable sources of quality farm supplies at a reasonable cost. Farmers created local farm supply cooperatives, which in turn created federated farm supply cooperatives, which in turn created

inter-regional cooperatives (or other kinds of arrangements) to work in concert to accomplish this objective. Farm supplies flow from the inter-regional cooperatives to the federated cooperatives and then to the local cooperatives and finally to the farmer patrons of the local cooperatives. Each system is ultimately owned and controlled by the farmer-patrons of the local cooperatives. All earnings generated by the system ultimately belong to the farmer-patrons of the local cooperatives, moving down through the system in the form of patronage dividends paid by the inter-regional cooperatives to the federated cooperatives, then by the federated cooperatives to the local cooperatives, and then by the local cooperatives to the farmer-patrons. These systems are designed to provide supplies to farmers at cost. The systems that have been developed by farm supply cooperatives are in many respects unique.

2. Cooperatives that are part of a farm supply cooperative system are normally required to own stock of other system entities to gain access to the supplies that flow through the system.

Most entities in farm supply cooperative systems are organized under special cooperative statutes that allow cooperatives to be formed on a stock basis. Typically, in a cooperative system organized on a stock basis, farmers own stock in local cooperatives, local cooperatives own stock in federated cooperatives, and federated cooperatives own stock in inter-regional cooperatives. Ownership of stock of a system entity normally confers the right to do business with that entity and the right to participate in its governance, but it rarely confers the full range of economic rights that typically accompany stock held in ordinary business corporations because cooperatives share their net savings on a patronage basis.

Generally, ordinary business corporations have a class of common stock which has the right to vote and to share in the earnings of the corporation. This stock can

appreciate in value without limitation if the corporation prospers. Ordinary business corporations also often issue preferred stock which has the right to preferred dividends (which are often limited), which often must be redeemed at some specified date in the future, and which has a preference upon liquidation of the company, but which does not share in the growth of the business or does so only to a limited extent.

Capital stock serves a different purpose in the cooperative world. The typical capital stock issued by a farm supply cooperative (whether local, federated or interregional) does not have a right to share in the cooperative's earnings – it does not bear dividends or provide any other kind of return to a holder. As described above, net savings of cooperative organizations are shared by member-patrons on a patronage basis, not on the basis of stock ownership. A member who owns stock in a farm supply cooperative, but does not buy from or otherwise patronize the cooperative, does not share in the cooperative's net savings. The typical stock issued by a farm supply cooperative does not have any appreciation potential. If the stock is redeemed, the holder normally is entitled to receive the par value of the stock (which is usually what the holder paid for the stock) and no more. Upon liquidation of the cooperative, holders of stock typically are entitled to receive the par value of the stock and no more. Residual assets of a cooperative (and thus any appreciation in the value of the business of the cooperative) are typically shared by member-patrons on the basis of their patronage over the years. Stock issued by a farm supply cooperative normally is not transferable and cannot be pledged. The shares of capital stock of farm supply cooperatives are not marketed or publicly traded. While cooperatives sometimes reserve the right to redeem the stock they issue at any time at par, members rarely have the right to compel a cooperative to redeem their stock.

With the characteristics described above, it should be readily apparent that the stock of a farm supply cooperative is quite different than the stock of an ordinary business corporation. Simply put, the capital stock of a supply cooperative is not viewed as an investment. Rather, it is viewed as a prerequisite to becoming part of a cooperative system and obtaining access to the farm supplies that flow through that system.

In *Rev. Rul. 78-402*, 1978-2 Cum. Bull. 138, the Internal Revenue Service recognized the unique features of the stock of cooperatives. That ruling held that stock purchased by a retailer in a cooperative wholesaler "was purchased and held predominantly for purposes related to the conduct of the . . . [retailer's] business, and not predominantly, for investment purposes." The ruling stated:

> the purchase and holding of the common stock of the cooperative by X was predominantly related to the conduct of the . . . [retailer's] business since it permitted X to avail itself of the cooperative's purchasing power, supply of products, and business services. In addition, no dividends were payable with respect to the stock, and because the cooperative stock was purchased at par and redeemable at the lower of par or book value, the optimum return X could expect to receive upon its redemption was the par value purchase price . . .

1978-2 Cum. Bull. 138, at 138-9.

This Court has recognized the unique characteristics of the stock issued by cooperative organizations. In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1974), this Court concluded that "stock" in a public housing cooperative is not a security within the meaning of the federal securities laws. While in the case of farm supply cooperative systems, ownership of stock is the key to obtaining access to a source of farm supplies, in a

housing cooperative, ownership of stock is the key to obtaining access to a living space. In *Forman*, this Court recognized the role of stock in a housing cooperative when it observed "[i]n the present case there can be no doubt that investors were attracted solely by the prospect of acquiring a place to live, and not by financial returns on their investments." 421 U.S. 837, at 853.

The ECI stock, whose character as a capital or ordinary asset is the issue of this case, had the characteristics described above. The stock was not entitled to dividends. It had no appreciation potential. Holders were limited to receiving par value upon redemption or liquidation. ECI had the right to call the stock, but the holders had no right to require redemption. The stock had no voting rights. However, it served as the key for Cenex to gain access to ECI as a source of supply of refined products. The Court of Appeals for the Federal Circuit observed that " . . . ownership of ECI stock was required to purchase ECI's petroleum products and ECI's output was allocated among its owners based on the number of shares each held." 156 F.3d 1377, at 1378.

3. NCFC is concerned that the decision of the Court of Appeals for the Federal Circuit improperly precludes cooperatives which are part of a farm supply cooperative system from treating stock in other system entities as an ordinary asset under the inventory exclusion of Section 1221(1) no matter what the circumstances.

As noted above, NCFC has long been concerned that the unique features of farm supply cooperative systems and of the role of capital stock in such systems might not be properly understood when considering whether stock owned by one member of the system in another should be characterized as a capital or ordinary asset.

Some years ago, a case involving the predecessor of one of the current members of NCFC correctly concluded that stock in an inter-regional cooperative which was part

of a farm supply cooperative system was not a capital asset. *FS Services, Inc. v. United States*, 413 F.2d 548 (Ct. Cl. 1969). The facts in that case parallel the facts in this case in many respects. Because of severe petroleum product shortages experienced in 1947, three federated farm supply cooperatives (one of whom, Farmers Union Central Exchange, later changed it name to Cenex and is the Petitioner in this case) formed an inter-regional cooperative which purchased and operated a refinery. In concluding that FS Services was entitled to treat as ordinary a loss that it incurred when it later disposed of its stock in the inter-regional cooperative, the Court of Claims cited and relied upon a number of cases that concluded that stock is not a capital asset if it is purchased and held in order to obtain a source of supply of a product required by the purchaser's business. These cases are frequently referred to as "source-of-supply" cases.

After *FS Services*, it was widely believed in the cooperative community that the "source-of-supply" cases applied to stock held by a cooperative in another cooperative or other entity in a farm supply cooperative system because those systems operated as cohesive units to provide a reliable source of quality farm supplies to farmers at a reasonable cost and stock ownership was a prerequisite to gaining access to the farm supplies. Many farmer cooperatives treated both gains and losses on such stock as ordinary.

Over the years, the case law related to the characterization of stock as a capital or ordinary asset expanded well beyond the facts of the original "source-of-supply" cases. The cases adopted a broader "business purpose" test, and stock was found to be an ordinary asset under circumstances that had nothing to do with obtaining a supply of a product used in the holder's business. The line between the original "source-of-supply" cases and the cases decided under the "business purpose" test became blurred. Cases which were actually "source-of-supply" cases began to be decided relying on the broader

"business purpose" rationale. While stock in farm supply cooperative systems satisfied either test, the blurring of the line of distinction between the two tests was of concern to the farmer cooperative community. There was concern that any effort to restrict instances where stock might qualify as an ordinary asset might lose sight of the strong factual foundation that provided the basis for the courts' conclusions in the original "source-of-supply" cases.

When this Court granted *certiorari* in *Arkansas Best Corporation v. Commissioner*, 485 U.S. 212 (1988), NCFC filed an *amicus curiae* brief with this Court to express its concern with some of the broad statements of the Eighth Circuit Court of Appeals in that case. In particular, NCFC was concerned with the Eighth Circuit's statement that it did not believe that there was a basis for "the courts to decide that capital stock can be anything other than a capital asset under section 1221." 800 F.2d 215, at 221. The *Arkansas Best* case was clearly not a "source-of-supply" case; rather it relied upon an expansive interpretation of the "business purpose" test. However, the Eighth Circuit opinion rejected both the "business purpose" test and the "source-of-supply" cases. NCFC objected to the rejection of the "source-of-supply" cases, particularly since there was no factual basis for the taxpayer in *Arkansas Best* to rely upon the "source-of-supply" cases in defense of its position.

When this Court decided *Arkansas Best*, it left no doubt that it rejected the "business purpose" test as a separate basis for concluding that assets are not capital assets. However, the opinion did not adopt the view expressed by the Court of Appeals for the Eighth Circuit that stock is always a capital asset except in the hands of a securities dealer. It was silent as to the circumstances that might justify treatment of stock as an ordinary asset other than to observe that stock could be an ordinary asset in the hands of a securities dealer.

NCFC does not view the opinion of this Court in *Arkansas Best* as rejecting the "source-of-supply" cases. While *Booth Newspapers, Inc v. United States*, 303 F.2d 916 (Ct. Cl. 1962), one of the "source-of-supply" cases, is cited in footnotes 4 and 7 of *Arkansas Best* (485 U.S. 212, at 216-217 and 222), *Booth Newspapers* was a case where the distinction between the "source-of-supply" rationale and the "business purpose" rationale was blurred. There is no further discussion of *Booth Newspapers* or mention of other "source-of-supply" cases elsewhere in *Arkansas Best*.

The concern to the NCFC is that the lower courts in the present case apparently share the belief that this Court rejected the "source-of-supply" decision in *Arkansas Best*. *Cenex, Inc. v. United States*, 38 Fed. Cl. 331 (Ct. Fed. Cl. 1997), *aff'd*, 156 F.3d 1377 (CAFC 1998). The Court of Federal Claims stated that "[u]nless the taxpayer in question is a dealer in securities, an ownership interest in a corporation cannot fit within even a strained interpretation of the term 'inventory.' " 38 Fed. Cl. 331, at 339. The Court of Appeals for the Federal Circuit summarily rejected the "source-of-supply" cases with the observation that "we believe the source of supply doctrine is incompatible with *Arkansas Best*." 156 F.3d 1377, at 1380.

The characterization of stock in farm supply cooperative systems as an ordinary asset continues to be an important issue for the members of NCFC. For reasons described in greater detail below, NCFC believes that the "source-of-supply" cases are compatible with the decision of this Court in *Arkansas Best*. NCFC believes that the Court should grant *certiorari* in this case and confirm the continued validity of the "source-of-supply" cases where the evidence demonstrates that ownership of stock is an integral part of an inventory-acquisition system. That clearly was so in the case of Cenex's ownership of stock in ECI, which along with Cenex and Cenex's members made up an integrated farm supply cooperative system sharing the common objective of providing

farmers with a reliable source of quality petroleum products at a reasonable price.

SUMMARY OF ARGUMENT

NCFC believes there is continued validity to the "source-of-supply" cases where the evidence demonstrates that stock ownership is an integral part of an inventory-acquisition system.

The *Arkansas Best* decision addressed the proper standards to be applied in determining whether an asset is a capital asset. It observed that "the definition of 'capital asset' must be narrowly applied and its exclusions interpreted broadly . . . . " 485 U.S. 212, at 220. While the *Arkansas Best* decision clearly rejected the "business purpose" test as a basis for characterizing stock as an ordinary asset, it did not address whether there were circumstances, short of being a dealer in securities, that would justify treating stock as an ordinary asset. In particular, it did not address whether the circumstances such as those found in the "source-of-supply" cases justify treating stock as an ordinary asset under the inventory exclusion.

The lower courts in this case have effectively taken the position that, except in the hands of securities dealers, stock can never be an ordinary asset and that the "source-of-supply" cases are incompatible with *Arkansas Best*. NCFC believes that both of these positions are in error and that this Court should grant *certiorari* and reverse the judgment of the Court of Appeals for the Federal Circuit and end the confusion that exists in this area. This case is important to NCFC and its members because many of its members are participants in farm supply cooperative systems. As such, they are concerned with the rejection by the lower courts in this case of the continued validity of the "source-of-supply" rationale for treating stock they own in other system entities as an ordinary asset.

REASONS FOR GRANTING THE WRIT

1. The decisions of the Court of Federal Claims and Court of Appeals for the Federal Circuit in this case indicate that confusion exists as to whether under appropriate circumstances capital stock can be treated as an ordinary asset, and this Court should resolve that confusion.

The focus of this Court in *Arkansas Best* was upon the proper standards to be applied in determining whether an asset is a capital asset. At issue was the interpretation of a prior decision of this Court, *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), which concluded that corn futures contracts purchased and sold by a corn processor as a hedge were ordinary assets. Observing that "the definition of 'capital asset' must be narrowly applied and its exclusions interpreted broadly . . . . " (485 U.S. 212, at 220) this Court concluded that *Corn Products* rested upon "a broad reading of the inventory exclusion of Section 1221 . . . . " (485 U.S. 212, at 223) and not upon a nonstatutory business purpose or connection exception to capital asset classification.

The *Arkansas Best* decision contains a careful analysis of why hedging transactions can be said to fall within the inventory exclusion. It does not contain any analysis of whether, under appropriate circumstances, ownership of stock can fall within the inventory exclusion because such an analysis was not required to dispose of the case. This Court stated simply:

> Arkansas Best, which is not a dealer in securities, has never suggested that the Bank stock falls within the inventory exclusion. *Corn Products* thus has no application to this case.

485 U.S. 212, at 222.

The lower courts in this case appear to have interpreted *Arkansas Best* as precluding them from treating stock as an ordinary asset unless the stock serves a hedging function substantially similar to that served by the

corn futures contracts purchased by Corn Products or unless it was held by a dealer in securities. Such an interpretation is not consistent with this Court's direction in *Arkansas Best* to interpret the exclusions to the definition of capital asset "broadly." 485 U.S. 212, at 220.[3] It is submitted that ownership of stock of a cooperative or other entity which is part of a farm supply cooperative system is much easier to view as part of an "inventory-purchase system" than ownership of corn futures contracts. As described above, ownership of such stock is the key to access to a system which provides a reliable source of quality farm supplies at a reasonable price. The futures contracts provided Corn Products limited protection if prices went up or supplies tightened within a relatively short time frame. Corn Products only occasionally used the futures contracts to obtain corn. In contrast, cooperatives that are a part of a farm supply cooperative system continuously obtain farm supplies from other system entities. Through ownership of other entities in the system, they receive access to and assurance of a reliable source of quality products at a reasonable cost, something that Corn Products' corn futures contracts could not provide.

Apparently the lower courts in this case believed they were precluded by this Court's opinion in *Arkansas Best* from considering factors such as were present in many of the "source-of-supply" cases in determining whether Cenex's ownership of ECI met the inventory exclusion.[4] While this Court rejected the "business

---

[3] Other courts have followed the direction of this Court to interpret the exclusions to the definition of capital asset broadly. See, for instance, *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993) (hedging transactions found to be an integral part of a system for buying and selling mortgages coming within the Section 1221(4) note receivable exclusion).

[4] An earlier decision of the Claims Court held that the "source-of-supply" cases are still valid under this Court's

purpose" test as establishing an independent basis for concluding that an asset was not capital, at the same time it acknowledged the obvious necessity of considering "business connection" in determining whether an asset qualifies for one of the exclusions, including the inventory exclusion:

> A business connection, although irrelevant to the initial determination of whether an item is a capital asset, is relevant in determining the applicability of certain of the statutory exceptions, including the inventory exception. The close connection between the futures transactions and the taxpayer's business in *Corn Products* was crucial to whether the corn futures could be considered surrogates for the stored inventory of raw corn. For if the futures dealings were not part of the company's inventory-purchase system, and instead amounted simply to speculation in corn futures, they could not be considered substitutes for the company's corn inventory, and would fall outside even a broad reading of the inventory exclusion.

485 U.S. 212, at 221-222.

This Court should grant *certiorari* in this case to clarify that where stock of a corporate supplier is purchased and held in order to gain access to a reliable supply of inventory, that business motivation is properly taken into account to determine whether such stock is a "surrogate" for inventory property described in Section 1221(1). This Court should confirm that in the case of stock purchased

---

rationale in *Arkansas Best. Circle K Corporation v. United States*, 23 Cl. Ct. 665 (1991). This decision was subsequently vacated by the Court of Federal Claims "to facilitate settlement." Unpublished order dated November 15, 1996, unofficially reported at 97-1 U.S.T.C. ¶ 50,338 (Ct. Fed. Cl. 1996). There is no indication in the order that vacation reflected any change in the views expressed by the Judge in his original opinion.

under such circumstances, surrogacy treatment is permitted under *Arkansas Best* if the taxpayer can demonstrate that the stock bears a "close connection" to its business and, by reason of such connection, is an "integral part of" the "inventory-purchase system" of that business. 485 U.S. 212, at 221-222. "Source-of-supply" circumstances present the clearest factual basis for establishing the requisite "close connection" to actual inventory under a section 1221(1) surrogacy analysis.

2. Because this case involves ownership of stock of a cooperative which is part of a farm supply cooperative system, it presents a compelling vehicle for a reexamination of the scope of the inventory exclusion.

The evolution of typical farm supply cooperative systems and how they are organized, operated and controlled are outlined above. In addition, the peculiar characteristics of the stock commonly issued by entities in such systems are described above.

The common objective of all entities that are part of a farm supply cooperative system is obtaining a reliable source of quality farm supplies at reasonable prices for the farmers that ultimately are the members and owners of the system. Local cooperatives become members of (and obtain stock in) federated cooperatives to better accomplish this objective. Federated cooperatives become members of (and obtain stock in) inter-regional cooperatives to better accomplish this objective. Products produced or purchased by entities up the supply chain move down through the system to the farmer members of the local cooperatives at its base. Thus, in this case, the refined petroleum products produced by ECI were sold to Cenex and the other federated farm supply cooperative members of ECI, who, in turn, sold the refined petroleum products to their local farm supply cooperative members, who, in turn, sold the products to their farmer members.

In *Corn Products*, the corn futures contracts that Corn Products purchased were indistinguishable from corn futures contracts purchased by speculators, and thus this Court needed to look carefully at all of the facts to determine whether, as this Court stated in *Arkansas Best*, "the futures dealings . . . amounted simply to speculation in corn futures" or whether they were "part of the company's inventory-purchase system." 485 U.S. 212, at 221-222. As described in detail above, the stock purchased by members of a farm supply cooperative system in other cooperatives in the system can not be mistaken for or confused with the kind of stock that is purchased and sold by investors or speculators. Typical cooperative stock does not share in earnings or in any appreciation in the value of the cooperative – net savings are allocated to member-patrons of system entities on a patronage basis and distributed to them in the form of patronage dividends. That stands in sharp contrast with typical corporate stock which shares in earnings either without limit (in the case of common stock) or with limits, but on a preferred basis (in the case of preferred stock), and shares in increases in the value on the corporate enterprise either on an unlimited basis (in the case of common stock) or on a limited, but preferred basis (in the case of preferred stock). Because of the peculiar features of cooperative stock, there should be no confusion over whether the purchase of such stock is motivated by investment or speculative considerations. Purchase of the stock is the key to access to a reliable source of supply of quality farm supplies at a reasonable price.

The stock that Cenex and the other members of ECI purchased and held in ECI had the features of the typical cooperative stock described above. It is clear that Cenex purchased and held that stock for reasons other than investment or speculation. In fact, as the lower court opinions reveal, Cenex was required to purchase the stock if it wanted access to ECI's products. The Court of Appeals for the Federal Circuit observes:

> ECI's corporate structure was set up so that ownership of ECI stock was required to purchase ECI's petroleum products and ECI's output was allocated among its owners based on the number of shares each held.

156 F.3d 1377, at 1378. The Court of Appeals for the Federal Circuit also observes that the federated cooperatives formed ECI "in order to obtain an assured supply of refined petroleum products . . . " 156 F.3d 1377, at 1377. Why Cenex purchased and held the stock in ECI should not be in doubt. It did so to obtain a reliable source of quality farm supplies at a reasonable cost so that it could serve its local cooperatives and their farmer members.

In short, because this case involves ownership of stock by one cooperative of another cooperative in a farm supply cooperative system, this is a compelling vehicle for revisiting the scope of the inventory exclusion and rejecting the position taken by the lower courts that the "source-of-supply" cases are incompatible with *Arkansas Best*. In the proper factual circumstances, stock purchased and held to obtain a "source-of-supply" should be regarded as an ordinary asset by virtue of the inventory exclusion to the definition of capital asset. This case presents such factual circumstances.

3. This is an important issue for members of NCFC.

In the opening section of this brief, we described in detail why this issue is of peculiar interest to NCFC and its members. Many of those members are part of farm supply cooperative systems. It is important to them that this Court address the scope of the inventory exclusion so that the status of the stock they own in other system entities can be resolved.

CONCLUSION

For all of the foregoing reasons, this Court should grant *certiorari* and reverse the decision of the Court of Appeals for the Federal Circuit.

Respectfully submitted,

GEORGE W. BENSON
(Counsel of Record)
KEVIN J. FEELEY
MCDERMOTT, WILL & EMERY
227 West Monroe Street
Chicago, Illinois 60606-5096
(312) 372-2000
Counsel for Amicus Curiae

Of Counsel:
JAMES S. KRZYMINSKI
National Council of Farmer Cooperatives
50 F Street, N.W.
Washington, D.C. 20001
(202) 626-8700

January 29, 1999